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Fitch: Investment Value Declines Erode Not-for-Profit Hospitals' Liquidity

Fitch Ratings-Austin/New York-10 January 2023: Not-for-profit hospitals' financial reserves have declined from 2021 peaks as a result of investment losses and increased liquidity demands to cover rising expenses, Fitch Ratings says. Not-for-profit hospitals generally have strong liquidity relative to debt repayment obligations and business risk, but recent unrestricted liquidity erosion is expected to bring balance sheet metrics more in line with pre-pandemic historical averages. Lower liquidity and lower operating margins could begin to have a negative effect on hospitals' credit profiles. As part of its rating analysis, Fitch assesses the size and allocation of a hospital's combined cash and investment portfolio to determine how cyclical market changes affect liquidity.

Equity markets appreciated meaningfully in 2021, pushing liquidity to all-time highs, with the median days' cash on hand reaching 260 days. Cash and investment portfolios have provided a significant rating cushion and helped hospitals weather significant operational challenges in 2022. This cushion has diminished with lower portfolio values as a result of market declines, causing key liquidity metrics to soften relative to an especially strong 2021.

Operating margins have compressed over the past year due to cost inflation, particularly staffing, and weaker liquidity will mean operations may have even less flexibility to address higher expenses. While cashflow generation may mitigate portfolio declines and bolster key leverage metrics, the expectation of continued expense pressures in 2023 may constrain cashflow generation. Health systems with comparatively weaker balance sheets for the rating category are more likely to face negative rating pressure in the current environment.

Higher-rated credits generally have stronger balance sheets, with cash to adjusted debt of 249.1% for 'AA' category credits, versus 102.3% for 'BBB' category credits (based on our 2021 medians). Higher-rated credits also tend to be larger, scaled systems with competitive positioning that mitigates balance sheet compression if investment performance weakens. While not as common, smaller organizations may have large financial cushion indicative of high-investment-grade ratings that may afford more flexibility to withstand higher asset volatility in investment portfolios.

While alternative investments can be part of a wider investment strategy, non-fixed-income asset classes have increased as a percentage of highly rated issuer portfolios over the past few years in the search for yield. An aggressive portfolio allocation is likely to result in more balance sheet volatility in a stressed economic environment.

Fitch conducts a sensitivity analysis on a hospital's investment portfolio using our portfolio analysis model (PAM) to assess changes in portfolio value, and therefore liquidity, through a typical economic cycle. Because our ratings reflect normal cyclical valuation changes, plausible market declines on their own should generally not affect ratings. The estimated portfolio value changes are considered in our analysis of an issuer's balance sheet to determine financial resiliency to market declines. Sustained declines beyond our expectations could result in negative rating action for credits with already weak liquidity.

PAM assesses the expected return and volatility of an issuer's portfolio by asset class, according to issuer specific return estimates in a base case and stress case, based on historic market return assumptions, and the percent of an issuer's holdings for those asset categories. The model then combines the results with operational scenarios and capital spending estimates, to generate an estimate of overall portfolio value over the course of five years.

Over the past few years, median investment income has been generally around 2% of revenue, measured as operating revenue and non-operating gains, for all Fitch-rated NFP hospitals. Overall, median investment income as a percent of total revenue and of EBITDA is generally higher for higher-rated entities due to larger balance sheets and investment portfolios. Conversely, median investment income as a percent of net income goes up as we move down the rating scale, as net income from operations is generally weaker at lower ratings.

For more information, please attend Fitch's 2023 Outlook – Not For Profit Hospitals discussion. Registration information can be found at events.fitchratings.com/2023outlooknotforprofithospitals

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